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CONGRESSIONAL TESTIMONY

The Impact of Higher Gasoline Prices on Household Costs and Income

Testimony before
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My name is David Kreutzer. I am Senior Policy Analyst for Energy Economics and Climate Change at The Heritage Foundation. The views I express in this testimony are my own, and should not be construed as representing any official position of The Heritage Foundation.

Mr. Chairman, I want to thank you and the other members of the Joint Economic Committee for this opportunity to address you concerning the impacts of higher energy prices on household income and expenses. I note that many colleagues have helped lay the foundation for the analysis I present here. In particular I want to thank Dr. Karen Campbell and request that her essay "How Rising Gas Prices Hurt American Households" be attached to the official record.[1]

Though many commodity prices have recorded large increases in the past two years, those of crude petroleum and its derivatives have been especially severe. My testimony, today, focuses on gasoline price increases and their effects on American households.

The EPA estimates that the typical light vehicle travels 12,000 miles per year and averages about 20 miles per gallon.[2] Doing the division indicates that the typical vehicle uses about 600 gallons per year. Further, the Department of Transportation data show that the average household owns nearly two cars.[3] Therefore, the direct impact of the past year's dollar per gallon price increase costs the average household about $1,100 per year.

Of course, a portion of this increased cost comes back to some households in the form of more hours or higher wages for those employed in the petroleum industry. A portion also works its way back via pension funds, IRAs, money-market funds and other financial instruments that contain stocks of companies benefiting from higher gasoline prices.

On the other hand (I am an economist), higher gasoline prices can have indirect impacts on income and employment that are distinctly negative.

Among other things, the Center for Data Analysis at the Heritage Foundation has the capability to analyze broad, economy-wide impacts of changes in energy prices. This past spring we analyzed the impacts of higher energy costs that might result from policies to restrict carbon dioxide emissions.

More recently, the Center analyzed what would be the impact of a two-dollar per gallon increase in the price of gasoline on employment, aggregate income and expenditure.[4] In addition to economy-wide impacts, this exercise also measured the impact on three

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[1] Karen A. Campbell, "How Rising Gas Prices Hurt American Households," *Backgrounder*, No. 2162, The Heritage Foundation, July 14, 2008, http://www.heritage.org/Research/Economy/bg2162.cfm.

[2] http://www.epa.gov/oms/climate/420f05004.htm

[3] 1.9 per household for 2001. http://www.fhwa.dot.gov/ohim/hiq/bar2.htm

[4] Karen A. Campbell, op. cit.

representative households. Though the analysis is forward-looking and investigates the impacts of gasoline price increases (as opposed to general energy-price increases), the results are useful in reflecting on the similar-sized gasoline price increases of the past couple of years.

As already mentioned, price increases have the obvious direct impact on gasoline expenditures. But, these direct impacts ripple through the economy to produce additional burdens on households.

Higher gasoline prices squeeze the production side of the economy from both the demand and costs directions. Consumers' demand for output drops as they divert expenditures from other items to gasoline. In addition, gasoline is a factor of production in the distribution of goods and services. Faced with higher costs, producers raise their prices. But the lower demand prevents the prices from rising enough to completely offset cost increases. This leads to production cuts and, therefore, to lower employment. In turn, these conditions put downward pressure on wages and salaries.

This model assumes a two-dollar price increase over a two-year period, with the majority of the price increase occurring in the first year. In this situation, total employment drops by 586,000 jobs. Disposable personal income drops by $532 billion. Because households dig into their savings, personal consumption expenditures drop by the smaller, but significant, amount of $400 billion.

For the category "Married, 2 Children" the median income in 2006 was $86,807. The impact of the gasoline prices reduces the household's income by over $1,000 per year. The response is to both cut expenditures and to withdraw from savings to make up for the loss. Of course, for many households the economists' term "withdrawing from savings" means borrowing.

The income losses are, on average, a combination of reduced wages and reduced hours. These reductions are in comparison to the baseline of no gasoline price increase.

It is notable that the impact of gasoline price increases extends beyond the period of the price increases, even if prices return to their original levels. This is because withdrawals from saving and household borrowing, forces wealth below the baseline level unless and until the wealth is rebuilt with increased future savings. And periods with increased savings will necessarily have consumption that is lower than it otherwise would have been.

Recommendations

Higher gasoline prices have serious negative impacts on household incomes, savings, employment and expenditures. It is important that federal policy not inhibit efficient responses to market shocks.

First, impediments to environmentally sensitive exploration and production should be removed. Maintaining and increasing the supply of petroleum is critical to avoiding high fuel prices. That there may be a significant delay between leases issued today and an increase in supply is an argument for moving more quickly on this issue. It is not an argument for not expanding supply at all.

In addition, a windfall profits tax would penalize those who made the decision to invest in oil resources and will only limit current and future oil supplies, raise fuel prices and further harm American households.

In 1974, 1979 and 1992 there were supply shocks that sent world petroleum and gasoline prices skyward. In 1974 and 1979 government policies, including price controls, distribution regulation and profit taxes, while very popular, extended and deepened the problems. In 1992, there was little interference with market adjustments and there were no gas lines nor extended high prices.

Substituting government mandates for market flexibility is politically tempting but ultimately harmful.

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